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SENSITIVE

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TREASURY FOR OASIA

E.O. 12958: N/A
TAGS: ECON EFIN EAGR EPET ENRG RP
SUBJECT: GRP RESPONSE TO RISING FOOD AND FUEL PRICES

REF: A) Manila 1050, B) Manila 1031, C) Manila 0838

SENSITIVE BUT UNCLASSIFIED

¶1. (SBU) Summary: Rising food and fuel prices in the Philippines have pushed up consumer price inflation to a fourteen-year high. The Philippine government continues to provide cheap rice for the poor and has scrapped duties on fuel, granted tax relief to personal income taxpayers, and postponed its balanced-budget goal in order to boost pro-poor spending. The government has been resisting calls to scrap the value added tax on fuel and electricity, impose price controls on basic commodities, and repeal the law that deregulated the downstream oil industry. Although President Gloria Arroyo's popularity rating is low, anti-government rallies thus far have been sporadic, contained, and led mainly by the political opposition and fringe groups. End Summary.

Food and Fuel Push Up Consumer Prices

¶2. (U) Accelerating since September 2007, year-on-year consumer price inflation climbed further to 11.4% in June, a 14-year high. The food index (47% of the consumer basket of a typical Filipino household) increased 17.4% year-on-year; rice prices soared by 43%. Rapidly rising international oil prices also are working their way into general price levels through increasing retail fuel prices, higher rates for electricity and public utilities, increased transportation costs and rising production and operating expenses. Domestic prices of diesel and unleaded gasoline are, for example, now about 64% and 48% higher than they were a year ago (currently about $5.15 per gallon for unleaded gas and about $4.88 per gallon for diesel).

Central Bank Shifts to Monetary Tightening Mode

¶3. (SBU) Year-on-year inflation averaged 7.6% during the first half of 2008. The Philippine Central Bank now forecasts that average inflation for the full-year will range from 9%-11%, up sharply from the original 3%-5% targeted range. For the first time in nearly three years, the monetary authority raised policy rates by 25 basis points in June and by another 50 basis points in July and has hinted of further monetary tightening to manage inflation expectations.

Food, Fuel and Poverty

¶4. (U) Rising food and fuel prices will aggravate poverty in a country where a third of the population already live below government-estimated poverty thresholds and more than 40% below the $2/day international poverty benchmark (Ref A). Asian Development

Bank economists recently estimated that every 10% hike in food prices pushes 2 million more Filipinos into poverty.

Government Rice Subsidies Continue

¶5. (U) Currently the world's largest rice importer, the Philippine government continues to sell rice at 18.25 pesos per kilogram (about $0.41 at current exchange rates) -- less than half of average commercial prices -- to impoverished families (Ref B). The National Food Authority (NFA), the state's grains trading firm -- already struggling with a negative $1.2 billion net worth and $1.7 billion in outstanding liabilities as of end-2007 -- expects its deficit to balloon to between 35-40 billion pesos (roughly $770-880 million) during 2008. NFA's debts represent contingent obligations on the part of the National Government.

Zero Tariffs on Oil and Personal Income Tax Relief
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¶6. (U) In January 2008, President Gloria Macapagal-Arroyo issued an executive order directing modifications on the 3% duty on imported petroleum products based on international oil price triggers. The tariff fell to 0% starting June 1. Department of Finance (DOF) officials estimate the measure could cost the government about 18 billion pesos ($400 million) in foregone revenues, but expects 37 billion pesos ($820 million) in "windfall" collections from the value-added tax on a higher-than projected oil and fuel import bill.

¶7. (U) In mid-June 2007, President Arroyo also signed a law (Republic Act 9504) providing relief to personal income tax payers

by increasing allowable deductions and exempting minimum wage earners from income tax. DOF officials expect 7 billion pesos ($155 million) in foregone revenues during 2008 from the income tax relief. They hope that accompanying provisions in the legislation to plug income tax leakages for the self-employed and corporate sectors will result in a revenue neutral legislation.

Heightened Monitoring but No to Price Controls...
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¶8. (U) The Government has resisted calls by some groups to impose price controls on basic commodities, but holds frequent dialogues with major manufacturers and oil firms to delay and/or temper price adjustments. In a recent initiative, the Department of Trade and Industry has been working with manufacturers to publish suggested retail prices and announced they would consider deviations beyond 10% from suggested prices in retail outlets as a red flag for profiteering.

...And to Repeal of Oil Deregulation Law

¶9. (SBU) The Philippine government also has resisted calls (including bills in the Philippine Congress) to repeal the 1998 Downstream Oil Industry Deregulation Act, as well as clamors from left-of-center groups to nationalize the Philippine oil industry. Convinced that such a response would only restrict supply and jar investor confidence, the government has depended mainly on moral suasion for oil companies to stagger price increases to appease public sentiment. Department of Engergy officials noted that vehicular traffic has eased in Metro Manila while metro-railway usage has risen by 20% to 500,000 passengers per day, suggesting that market-based fuel prices encourage conservation. The government plans to purchase more than 70 new light rail coaches in ¶2009.

¶10. (SBU) Warning of further, staggered adjustments, oil firms here note that domestic price increases are lagging international oil price trends. Results of a study commissioned by the Department of Energy, which looked at price trends and financial data from 2006 to early 2008, echoed this observation and cleared oil companies of abusive pricing behavior. Energy and Chevron officials told

econoffs that oil companies have been partially cross-subsidizing more socially sensitive petroleum products (such as diesel and kerosene) with gasoline prices. Chevron officials claim that oil companies have had under-recoveries for diesel and kerosene since February.

Keeping VAT on Fuel and Electricity

¶11. (SBU) The political opposition, emerging presidential candidates for the 2010 elections, and some members of the Catholic clergy have joined the clamor by fringe consumer, transport, and student groups to scrap the 12% value added tax on fuel and electricity. Legislation to this effect has already been filed in the Philippine Congress. Scrapping the VAT would reduce current diesel and gasoline prices by between 6 to 7 pesos ($0.13-0.16) per liter (equivalent to $0.50-0.60 per gallon). President Arroyo and her economic team have countered that such a move would mainly benefit the better-off segments of Philippine society (who consume more than 80% of fuel and power); derail fiscal stabilization efforts; rattle financial and credit markets; and deprive the government of nearly 100 billion pesos ($2.2 billion) in revenues to fund critical infrastructure and social spending programs during a globally challenging time.

¶12. (U) After offsetting estimated revenue losses from the scrapping of import duties on oil/fuel, the Philippine government expects about 19 billion pesos ($420 million) in net "windfall" gains during 2008 from the value-added tax on oil products. The Philippine government reported that the 8 billion pesos ($178 million) in excess value-added tax collections during the first half of the year have funded cash transfers to small electricity consumers; loans and scholarships for poor but deserving college students; the conversion of engines used by public transport vehicles to alternative-fuel use; the conversion from incandescent to fluorescent bulbs in government offices and public places; livelihood programs for families of public transportation drivers; upgrading of provincial hospitals; and disaster relief and rehabilitation.

Balanced-Budget Goal Deferred to 2010

¶13. (U) The Philippine government has officially pushed back its 2008 balanced-budget goal to 2010, but still hopes for fiscal deficits for 2008 and 2009 below 1% of Gross Domestic Product. For 2008, the government has announced it is prepared to hike the current budget by up to 75 billion pesos ($1.7 billion) to support, among others, agricultural productivity and food security goals and expand social safety nets for vulnerable sectors.

Silver Lining: An Opportunity for Reforms?

¶14. (SBU) The food and fuel-price issue is spurring action on long-stalled reforms such as passage of a renewable energy bill. Food security concerns have highlighted the role of biotechnology for boosting rice and food crops productivity. Linking over-population to poverty and food security, a number of legislators have vowed to push for more aggressive family planning and reproductive health bills, although this remains a contentious issue even among Cabinet officials. Government officials told econoffs that the President is seriously considering airing her support for natural family planning during the July 28 State of the Nation Address to improve strained relations with the influential Catholic Church.

¶15. (SBU) As part of ongoing negotiations between the government and World Bank for a food security loan, policy commitments may include rice policy reforms that would liberalize rice trade; allow private sector participation in rice importation; reduce the tariff (currently 50%) for rice; lift quantitative restrictions on rice over the medium-term; and limit the role of the financially-strapped National Food Authority to buffer stocking (Ref C). These measures

adopt reforms recommended a few months ago by a team of rice/agricultural experts funded by joint World Bank-USAID technical assistance.

Comment

¶16. (SBU) The country's leading social survey institution reported recently that President Arroyo's popularity rating has sunk to the lowest level recorded by a Philippine president since 1986. Nevertheless, more pragmatic businesspeople and economists, as well as international credit rating and multilateral donor agencies, credit President Arroyo for resisting populist proposals that could spell fiscal disaster and spook investors. Political rallies thus far -- led mainly by the political opposition and left-of-center groups -- have been sporadic and relatively contained, although anti-Arroyo forces may converge during the President's July 28 State of the Nation Address. As household budgets tighten, effective and transparent implementation of pro-poor strategies will gain in importance.

Kenney